

elect to have characterized as a lease described in section 168(f)(8). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Under the terms of the lease, X, the lessee-user, is obligated to pay Y nine annual payments of \$10,000 and, at the end of the lease term, Y has the option to sell the property to X for \$2,160,000. Under § 5c.168(f)(8)–7(d), the aggregate payments required to be made by X under the lease are \$2,250,000 (\$90,000 rent plus \$2,160,000 option price) and are treated as rent to Y (less a reasonable estimate for the residual value of the property) and taxable as such. Assuming a reasonable estimate of the residual value is zero, the full \$2,250,000 will be treated as rent, and under § 5c.168(f)(8)–7(d), such amount is deductible by X and includible in Y's income ratably over the term of the lease, *i.e.*, at a rate of \$250,000 per year (\$2,250,000 divided by 9).

Example (2). The facts are the same as in example (1) except that under the terms of the lease X is obligated to make rental payments of \$100,000 for each of the first 5 years of the lease and \$300,000 for each of the 4 remaining years under the lease. Further, X has an option to purchase the equipment for \$1.00 at the end of the lease term. Pursuant to § 5c.168(f)(8)–7(d), X's aggregate rental payments are deductible by X and are includible in Y's income ratably over the term of the lease. Thus, the annual rental payments are deemed to be \$188,000 per year (\$1,700,000 divided by 9).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981]

§ 5c.168(f)(8)–8 Loss of section 168(f)(8) protection; recapture.

(a) *In general.* Upon the occurrence of an event that causes an agreement to cease to be characterized as a lease under section 168(f)(8), the characterization of the lessor and lessee shall be determined without regard to section 168(f)(8).

(b) *Events which cause an agreement to cease to be characterized as a lease.* A disqualifying event shall cause an agreement to cease to be treated as a lease under section 168(f)(8) as of the date of the disqualifying event. A disqualifying event shall include the following:

(1) The lessor sells or assigns its interest in the lease or in the qualified leased property in a taxable transaction.

(2) The failure by the lessor to file a copy of the information return (or applicable statement) with its income tax

return as required in § 5c.168(f)(8)–2(a)(3)(iii).

(3) The lessee (or any transferee of the lessee's interest) sells or assigns its interest in the lease or in the qualified leased property in a transaction not described in § 5c.168(f)(8)–2(a)(6) and the transferee fails to execute, within the prescribed time, the consent described in § 5c.168(f)(8)–2(a)(5), or either the lessor or the transferee fail to file statements with their income tax returns as required by that paragraph.

(4) The property ceases to be section 38 property as defined in § 1.48–1 in the hands of the lessor or lessee, for example, due to its conversion to personal use or to use predominantly outside the United States, or to use by a lessee exempt from Federal income taxation.

(5) The lessor ceases to be a qualified lessor by becoming an electing small business corporation or a personal holding company (within the meaning of section 542(a)).

(6) The minimum investment of the lessor becomes less than 10 percent of the adjusted basis of the qualified leased property as described in section 168(f)(8)(B)(ii) and § 5c.168(f)(8)–4.

(7) The lease terminates.

(8) The property becomes subject to more than one lease for which an election is made under section 168(f)(8).

(9) Retirements and casualties. [Reserved]

(10) The property is transferred in a bankruptcy or similar proceeding and the lessor fails either to furnish the appropriate notification or to file a statement with its income tax return as required by § 5c.168(f)(8)–2(a)(6).

(11) The property is transferred in a bankruptcy or similar proceeding and not all lenders with perfected and timely interests in the property specifically exclude or release the Federal income tax ownership of the property as required under § 5c.168(f)(8)–2(a)(6)(iii.)

(12) The property is transferred subsequent to a bankruptcy or similar proceeding and the lessor fails to furnish notice to the transferee prior to the transfer or fails to file a statement with its income tax return, and either the lessor fails to secure the transferee's consent or the lessor or the transferee fail to file statements with their returns.

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(13) The property is leased under the provisions of section 168(f)(8)(D)(iii) and § 5c.168(f)(8)–6(b)(3) and ceases to be a qualified mass commuting vehicle.

(14) The failure by the lessor to file the required information return described in § 5c.168(f)(8)–2 (a)(3)(ii) by January 31, 1982, unless the lessee files such return by January 31, 1982.

(c) *Recapture.* The required amount of recapture of the investment tax credit and of accelerated cost recovery deductions after a disqualifying event shall be determined under sections 47 and 1245, respectively.

(d) *Consequences of loss of safe harbor protection.* The tax consequences of a disqualifying event depend upon the characterization of the parties without regard to section 168(f)(8). If the lessee would be the owner of the property without regard to section 168(f)(8), the disqualifying event will be deemed to be a sale of the qualified leased property by the lessor to the lessee. The amount realized by the lessor on the sale will include the outstanding amount (if any) of the lessor's debt on the property plus the sum of any other consideration received by the lessor. A disposition that results from a disqualifying event shall not be treated as an installment sale under section 453.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). M Corp. and N Corp. enter into a sale and leaseback transaction in which the leaseback agreement is characterized as a lease under section 168(f)(8) and M is treated as the lessor. In the second year of the lease, M becomes an electing small business corporation under subchapter S. The agreement ceases to be treated as a lease under section 168(f)(8) as of the date of the subchapter S election. Without respect to section 168(f)(8), N would be considered the owner of the property. The disqualification of M will be treated as a sale of the qualified leased property from M to N for the amount of the purchase money debt on the property then outstanding. M will realize gain or loss, depending upon its basis, with applicable investment tax credit and section 1245 recapture. N will acquire the property with a basis equal to the amount of the outstanding obligation. The property will not be used section 38 property to N under § 1.48–3(a)(2).

Example (2). Q Corp. (as lessor) and P Corp. (as lessee) enter into a lease that is characterized as a lease under section 168(f)(8). The lease has a 6-year term. P has no option to

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renew the lease or to purchase the property. At the end of 6 years, if P would be considered the owner of the property without regard to section 168(f)(8), upon the termination of the lease the property will be deemed to be sold by Q to P for the amount of the purchase money debt outstanding with respect to the property.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981; T.D. 7800, 46 FR 63259, Dec. 31, 1981]

§ 5c.168(f)(8)–9 Pass-through leases—transfer of only the investment tax credit to a party other than the ultimate user of the property. [Reserved]

§ 5c.168(f)(8)–10 Leases between related parties. [Reserved]

§ 5c.168(f)(8)–11 Consolidated returns. [Reserved]

§ 5c.1305–1 Special income averaging rules for taxpayers otherwise required to compute tax in accordance with § 5c.1256–3.

(a) *In general.* If an eligible individual (as defined in section 1303 and the regulations thereunder) is described in the first sentence of § 5c.1256–3(a), chooses the benefits of income averaging and otherwise complies with the special rules under section 1304 and the regulations thereunder, and has averagable income (as defined in section 1302 and the regulations thereunder) in excess of \$3,000, then the individual shall compute the tax under section 1301 as provided in this section. The computation under this section shall be in lieu of the computation under § 5c.1256–3.

(b) *Computation of tax.* The individual shall compute the tax under section 1301 as follows:

Step (1). Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for the taxable year which includes June 23, 1981.

Step (2). Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for taxable years beginning in 1982.